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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

BEFORE THE

Federal Communications Commission

WASHINGTON, D.C.

Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992	)	MM Docket No. 92-266
Rate Regulation	)	
Further Notice of Proposed Rulemaking	)	

REPLY COMMENTS OF TELE-COMMUNICATIONS, INC.

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July 2, 1993

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Tele-Communications, Inc. ("TCI"), by its attorneys, hereby submits its Reply Comments in response to the Further Notice of Proposed Rulemaking in the above-captioned docket.[1] The Further Notice proposes to order an additional rate cut (from 10% to 28%) for cable systems subject to rate regulation. As discussed below and in the attached paper by Dr. Stanley M. Besen and Dr. John R. Woodbury of Charles River Associates, the exclusion of these systems would only further weaken an already dubious basis for rate regulation. Moreover, the Commission

THERE IS NO BASIS IN THE RECORD FOR EXCLUDING LOW

[redacted]

Courts will overturn agency decisions based on faulty methodology.[5]

As Drs. Besen and Woodbury describe in the attached paper, the evidence adduced in this record forcefully militates against utilizing the Commission's methodology as a basis for further rate reductions. Although a very few parties filed in favor of the rate reduction proposal, their arguments do not support their conclusions.[6] Becuase the logical and analytical errors of those comments are analyzed in detail in the attached paper, our discussion will be brief.

Result-oriented classification of the data. The systems in the competitive sample only if these rates were similar to the rates of the overbuilt systems. But as Drs. Besen and Woodbury explain, CFA's reasoning provides no basis for concluding that the rates charged by the overbuild systems should be the sole basis on which other rates are to be judged.

Manipulation of the data to exclude rates that are either "too high" or "too low" cannot comport with reasoned decisionmaking. Administrative agencies are not permitted to manipulate information in order to reach a predetermined outcome. <u>See</u>, <u>e.g.</u> <u>National Lime Ass'n v. EPA</u>, 627 F.2d 416, 433, 443 (D.C Cir. 1980). As discussed below, a large number of variables could explain the variance in rates among systems, and no one class of systems can be assumed to be the "appropriate" measure for the remaining ones.

<u>Omitted Variables</u>. Virtually all of the commenters are

factors other than the presence of competing multichannel program providers.[8] The solution, as explained by Drs. Besen and Woodbury, however, is not to ignore these important factors but to develop a model that controls for these missing variables.

Professor Hazlett suggests that low demand may affect the rates of low penetration systems and he identifies a number of factors that contribute to low demand. Yet, as Drs. Besen and Woodbury discuss in their paper, low demand does not necessarily mean that low penetration system prices are set at non-competitive levels. Drs. Besen and Woodbury explain that because there are large fixed costs associated with cable service, these costs must be spread among fewer subscribers in areas with low penetration, such that the price for each subscriber will be relatively high. As Drs. Besen and Woodbury note, "[i]n 'low demand' areas, a cable operator may find it profitable to operate prices. In fact, these systems may be earning only competitive returns, and some may not even be earning returns which cover comparative standard for rates in the immediate future."[13] Yet, at another point, CFA argues that the benchmark rates should be based only on data from overbuilt systems.[14] CFA cannot have it both ways.

The competitive benchmark is based on data for only 101 effectively competitive systems. Excluding data from the low penetration systems reduces the number of independent observations to less than 50. And if, as CFA suggests, the Commission were to exclude the rates of municipally-owned systems, this number would drop to 29. Fewer than 50 systems is simply too small a number to provide a basis on which to regulate an industry comparing more than 10,000 systems. Courts have overturned agency actions that rely upon insufficient or inadequate data. See, e.g., National Lime Ass'n v. EPA, 627 F.2d at 432 (agency must consider the representativeness for the industry of a whole of the sample on which it relies); Cf. Permian Basin Rate Cases, 390 U.S. 747, 769 (1968), reh'g denied, 392 U.S. 917 (1968) ("it has been thought to be sufficient if the agency has before it representative evidence, ample in quality to measure with appropriate precision the financial and other requirements of the pertinent parties").

Moreover, the problem of small sample size will be exacerbated if, as Drs. Besen and Woodbury explained in their

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[13] Data Analysis of Consumer Federation of America, filed March 8, 1993, at 15.

[14] Comments of Consumer Federation of America, filed June 17, 1993, at 7.

earlier paper, the Commission corrects one of the model's major flaws -- accounting for system size. If the Commission were to [illegible] this and calculate competitive differentials by system competition," that alone is not sufficient. Should it reject Congress' definition, the Commission would confront a separate and independent obligation to consider the validity of alternative competitive benchmark data sources, both those which it has already collected and other reasonable alternatives.

Further, given the numerous and significant problems

CONCLUSION

TCI respectfully submits that the Commission must reject the proposal of the Further Notice. The record does not support excluding low penetration systems from the calculation of

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A FURTHER ANALYSIS OF THE FCC'S CABLE TELEVISION BENCHMARK RATES

July 2, 1993

Stanley M. Besen
John R. Woodbury

CHARLES RIVER ASSOCIATES

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Introduction

In its Further Notice of Proposed Rulemaking, the Commission has requested comments on whether it should exclude cable systems with less than 30 percent penetration, the "low penetration" systems, from its sample of "effectively competitive" systems in calculating benchmark rates for cable service and equipment.[1]

In our comments on the Further Notice, we identified four major concerns about the Commission's estimate of the competitive differential and expressed considerable skepticism about the robustness of the competitive benchmarks to attempts to deal with these problems.[2] These concerns were: (1) misspecification of the Commission's equation because competitive and non-effectively competitive systems may differ for reasons other than the presence or absence of competition; (2) misspecification of the equation because the coefficients of the Commission's variables differ among systems of different sizes; (3) the fewness of the number of effectively competitive systems in the Commission's sample relative to the way in which the results are being used; and (4) weaknesses in the data, especially with respect to equipment prices.

We also emphasized that, while the Commission could deal with some of these concerns, there was little it could do to increase the number of observations of effectively competitive systems and,

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[1]Report and Order and Further Notice of Proposed Rulemaking In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, Adopted: April 1, 1993.

[2]Stanley M. Besen and John R. Woodbury, "An Analysis of the FCC's Cable Television Benchmark Rates," June 17, 1993, p. 19.

indeed, the problems associated with the small number of observations would be exacerbated if the Commission were to eliminate observations on the low penetration systems from its analysis. These points are reinforced by comments in this proceeding as well as in filings that request reconsideration of the Commission's initial rate Order.

Relying on circular arguments

At the outset, we note that some of the commenters have relied on tautologies to justify excluding the low penetration systems from the sample. For example, the Consumer Federation of America (CFA) wishes to exclude low penetration systems because "these systems have prices in the range of monopoly systems."[3] At the same time, it wishes to exclude municipal systems because they "had lower prices than other competitive market systems."[4] In effect, CFA has defined the rates charged by overbuilt systems as the standard by which other rates are to be judged.[5] In CFA's logic, observations for both low penetration and municipal systems should be excluded from the analysis because their rates differ from those of overbuilt systems. Only if the low penetration and municipal systems were to charge the same rates as the overbuilt systems would CFA wish to retain these observations. But, of course, this

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[3]Comments of the Consumer Federation of America. June 17.

means that these observations would be retained only if they contained no information that is not already present in the data for overbuilt systems!

Similarly, in joint comments, Bell Atlantic, GTE, and NYNEX assert that "high prices, coupled with unusually low consumer demand, are the causes of low penetration and that multichannel video competition is not a factor."[6] In arguing for the exclusion of low penetration systems, the joint comments echo the circularity of the CFA comments by treating the difference between the rates of overbuilt and low penetration systems as evidence that the latter are not competitive.[7] We would urge the Commission simply to reject such circular reasoning as any basis for modification of the "effectively competitive" sample.

Omitted Variables[8]

CFA argues in its Data Analysis that there are important differences between "young" and "old" low penetration systems, but

[6]Joint Comments of Bell Atlantic, GTE, and the NYNEX Telephone Companies, June 17, 1993. The comments are actually dated June 17, 1992.

[7]"...the average rates of low penetration systems are so significantly higher than those of systems facing multichannel video competition that including them in the calculations of a competitive rate level dramatically skews the result...." (Ibid., p. 6) Later, the joint commenters identify overbuilt systems with competitive systems when they note that the rates of the low penetration systems "exceed those of competitive systems." (Ibid., p. 13)

[8]We should stress, as we did in our comments, that we are concerned with misspecification of the Commission's equation primarily because it may affect the estimated competitive differential.

that "within both the older and younger group (sic), competitive and monopoly systems are much more similar in terms of households passed, subscribers, density, type of wiring and number of headends."[9] But if this is the case, the solution is not to exclude the observations for the low penetration systems from the analysis but instead to control either for differences in system age or for differences in the "cost causative characteristics" identified by CFA as being associated with age.

In its joint comments, Bell Atlantic, NYNEX, and GTE argue for the exclusion of the low penetration systems based in part on information contained in an affidavit produced by Thomas W. Hazlett.[10] It should be noted at the outset that Hazlett does <u>not</u> endorse the benchmark approach. He states: "In my view, the Commission's undertaking to regulate price using a benchmark approach will create enforcement difficulties."[11] Thus, Hazlett's affidavit should not be regarded as support for the approach to regulation advocated by the joint commenters.

Hazlett undertook an examination of the low penetration systems and apparently determined that "the low penetration rates

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[9]<u>Ibid.</u>, p. 9. Again, CFA treats competitive systems as synonymous with overbuilt systems.

[10]Affidavit of Thomas W. Hazlett, June 16, 1993.

[11]<u>Id.</u>, p. 2, footnote 1. Elsewhere, Hazlett has expressed considerable skepticism about regulation in general. See, e.g., "Private Contracting versus Public Regulation as a Solution to the Natural Monopoly Problem," in Robert W. Poole, (editor), <u>Unnatural Monopolies</u>, Lexington, MA: D.C. Heath, 1985, pp. 71-114.

found in these systems are attributable to factors other than the presence of competing multi-channel video service providers."[12] It is unclear, however, why Hazlett should have expected the presence of multichannel competitors to be a factor in the markets of the low penetration systems. Presumably, if a cable system faced a multichannel competitor, the observation would have been classified as an overbuilt, as opposed to a low penetration, system.

Hazlett makes much of the fact that, because a substantial number of homes in some cable systems' franchise areas are not passed, measured penetration rates are smaller than the ratio of subscribers to homes passed for a number of low penetration systems. Hazlett does not question, however, why these systems choose not to serve their entire franchise areas despite what he apparently believes are supra-competitive prices. The most plausible reason, of course, is that even at these prices, the cable system cannot cover the incremental costs of extending its service to other portions of its franchise area.

Hazlett also claims that high prices are a cause of low penetration.[13] However, prominent on the list of "Other Non-

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[12] Ibid., p. 3.

[13] Ibid., p. 5-7. We should note here that the comparison of prices among different types of cable systems in Hazlett's Table 2 does not control for any differences among these systems other than their competitive status. We also take issue with Hazlett's claim that the municipal systems are indisputably competitive. (Id., p. 6.) Indeed, he apparently believes that all such systems are municipal "overbuilds" (Id., p. 3, footnote 4) when some are simply municipal systems.

Competitive Factors that Lower Penetration"[14] that Hazlett cites is "low community demand for cable" [15] and he stresses a number charge prices that covered the high per subscriber costs they would experience at low penetration levels.

The clear implication of this analysis is not that observations on low penetration systems should be excluded from the equation used to estimate the competitive differential. Indeed, Hazlett's descriptions of these systems reinforces the view that they are earning competitive returns at best, and many may be having difficulty in covering their costs.[18] What Hazlett's survey results suggest is that estimating the competitive differential may require accounting for factors that affect system costs and the level of demand in addition to those that appear in the Commission's equation.[19]

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[18]A similar point is made in Daniel Kelley, "Economic Issues Raised by the Further Notice," June 17, 1993, pp. 5-6, appended to Comments of Time Warner Entertainment Company, L.P., June 17, 1993.

[19]In Appendix E -- Survey Results: Technical Issues to its initial Order, the Commission notes that the stepwise regression procedure that it used "was not an attempt to model demand and supply, but rather an empirical exercise to determine the relationship between prices and various other characteristics of cable community units." (para. 26) As we observed in our comments to the Further Notice, the Appendix provides only a sketchy description of the variables the Commission considered, and it does not describe the sensitivity of the estimated competitive differential to changes in the specification of its equation. In addition, while the methodology used by the Commission might be suitable for an exercise that merely seeks to predict cable rates, it is completely inappropriate when one is attempting to estimate the effects of specific factors, in this case the effect of "competition," on rates. This is so because the omission of relevant variables from the analysis can bias the estimated effect. The Commission's stepwise approach makes it impossible to conclude that competition is the cause of any differential because the differential may be due to other factors that are omitted from the analysis and whose effect is incorrectly ascribed to the "effective competition" variable.

Similarly, Shew, in a Declaration appended to the Comments of the Coalition of Small System Operators[20], found that "in franchise areas where the duration of competition was five years or less prices were 30% lower than in those franchises where competition had endured at least six years" and that the difference was statistically significant.[21]

In addition, we reported in our comments that, when systems are categorized into the GAO size classes, there are significant differences between the coefficients of the Commission's explanatory variables for the effectively competitive and other systems.[22] This means that a number of "interaction" variables have been omitted from the Commission's equation. It also means that the competitive differential, rather than being a single number, will depend on the characteristics of the system to which it is being applied.

In short, however complete the Commission may have thought its list of explanatory variables, the comments in this proceeding indicate that the list may be far too short to permit accurate estimation of a competitive differential that will serve as a basis for widespread rate regulation.

Differences in the Competitive Differential by System Size

In our comments in this proceeding, we noted that there are significant differences in the estimated competitive differentials when systems are separated into the GAO size classes.[23] This finding has been confirmed in a report appended to Comments of Time Warner submitted in this proceeding.[24] This report finds: (1) a significant reduction in the unexplained variance in rates when separate coefficients are estimated for systems with less than and more than 10,000 subscribers; and (2) the estimated coefficient of

A few of the commenters report problems with the Commission's data.[27] We would re-emphasize here our own difficulties with reconciling our analysis of the reported equipment prices with the Commission's use of those data.[28] Where the Commission apparently also noted that the omission of observations for the low penetration systems would reduce the number of independent observations to fewer than 50[33], a point that is echoed in Kelley's appendix to Time Warner's Comments.[34]

In its Comments, CFA urges the Commission to "recalculate the benchmarks by discounting low penetration and municipally owned used as the sole basis for determining benchmark rates.[39] But if this is so, CFA cannot now argue that benchmark rates can be established using data only on overbuilt systems. Nothing has happened between March and June to overcome the fewness, or the unrepresentativeness, of the observations on overbuilt systems. As we pointed out in our comments in this proceeding, the approach that CFA now advocates would result in basing the entire rate regulatory scheme for the cable television industry on data for only 29 presumably "unique" overbuilt systems![40]

The problem of small sample size is further exacerbated if, as appears to be the case, it is necessary to estimate different equations for different system size classes. Shew notes that there are only 45 competitive systems with fewer than 1,000 subscribers, even if the low penetration systems are retained.[41] If the low

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[39]We also share some of CFA's skepticism about the data obtained by the Commission's survey and we have identified additional sources of concern -- especially with regard to equipment rates -- in our own comments in this proceeding.

[40]In light of these problems, CFA argues that "our formula would provide the Commission with a more effective method for carrying out Congress' intent than the approach adopted in the Report and Order. Comments of the Consumer Federation of America, p. 4, footnote 5. The reference here is to the "formulaic" described in CFA's filing in the initial Notice. However, adopting this formulaic would be a serious mistake since, despite CFA's claims, it would create a significant disincentive to the carriage by cable systems of additional programming. In addition, some services may be forced to reduce their quality to be able to cover their costs at the rates that would result under the CFA plan. For a further discussion of these issues, see Reply Comments of Tele-Communications, Inc., Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, Rate Regulation, MM Docket No. 92-266, February 11, 1993, pp. 17-28.

[41]Op. cit., pp. 8-9. Actually, there are only 45 effectively competitive units, so that the number of systems is even smaller.

penetration systems are eliminated, this number declines to 13! If the division were made at 10,000 subscribers as one study seems to suggest[42], there would be only 38 competitive units, and of course even fewer systems, greater than that size. The number would be even smaller if observations on the low penetration systems were eliminated.

Conclusion

It is clear that the Commission's equation for estimating the competitive differential, as well as the data on which it is based, are subject to numerous shortcomings. One of these shortcomings is that the parameters of the equation differ significantly for systems of different size. With the number of observations on competitive systems already inadequate to the regulatory task to which they are being applied, the small sample size problem will become even more damaging if the Commission must estimate different equations for different size classes.

It has now been suggested that some of the observations on competitive systems should be eliminated from the analysis. In addition to the elimination of all low penetration systems, it has been proposed that municipal systems be eliminated (CFA) and that new overbuilt systems be eliminated (Shew). Accepting any of these